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SUBJECT: BOOMING SRI LANKAN STOCK MARKET SHOWS ECONOMIC  
CONFIDENCE

¶1. Summary. The Colombo Stock Exchange (CSE) surged to a record high in early October, making it the world's second best performing stock market in 2009. According to analysts, the CSE is rising due to the end of the Sri Lankan civil war (thereby lowering the risk premium for the country), lower interest rates, expectations of post war economic growth, and increased investor confidence after the IMF loan. Local investors have led the boom, although foreign investors are starting to invest as well. End Summary.

#### A Booming Stock Market

¶2. The Colombo Stock Exchange's All Share Price Index (ASPI) closed at 3,098 points on October 5, the highest level ever. The ASPI measures the price of shares of all of the listed companies. The ASPI has recorded a remarkable growth of 106.8 percent for this year, making the CE the second best performing stock market in the world after Lima's stock market. The market has risen over 60 percent since May. According to Nihal Fonseka, president of the CSE, there have been two bursts of investing, immediately after the end of the war in May and in the last two months.

¶3. The end of the war, combined with future expectations of economic growth, are the biggest reasons for the rise of the stock market. Chinthaka Ranasinghe, head of research at John Keells Holdings Stock Brokers (JHK-SB), observed that the long brutal civil war has been the largest obstacle for the local economy, so the end of the war has boosted investor confidence. Simultaneously, the war risk premium has been removed from the CSE. Other factors helping the market include declining interest rates, low inflation, stability of the rupee, improved foreign exchange reserves and post war economic growth potential.

¶4. The highest levels of growth have been in companies associated with post war construction and tourism. All sub-sectors in the CSE have performed well in 2009, with construction (up 286 percent) investment trusts (208 percent), hotels and tourism (123 percent), local conglomerates (157 percent) and banks (123 percent) outperforming the market. Ranasinghe asserted that the earning potential for the entire market is high. While some equities have been pushed by speculators and may not match their fundamentals, the improved economic outlook has made investors optimistic. JHK-SB analysts expect a moderate improvement in corporate earnings in FY 2010 (ending March 2010) and that a significant peace dividend will be seen in company earnings in FY 2011 (April 2010-March 2011). Their

analysis is based on reconstruction programs and renewed economic activities in the North and East, infrastructure projects in the South, a strong rebound in tourism and increased capital inflows and investment.

#### CSE Demonstrates Local Confidence in the Economy

¶5. The CSE lists 230 companies; most are large local companies, but there are also a few multinational firms. Important sectors like garments and infrastructure are not listed in the CSE and therefore not included in the ASPI. The investors include not only the wealthy, but also upper middle class and retired Sri Lankans.

¶6. The growth in the CSE is primarily driven by local investors. According to analysts, local investors are shifting their money from fixed rate instruments to equities due to lower interest rates and expectations of low inflation. Benchmark three month Treasury bill yields have declined 774 basis points from a year ago to a five year low of 9.48 percent. Inflation is at a record low of 0.7 percent. Total CSE volume in the first nine months of 2009 was Rs 87 billion (\$756 million), with foreign investors contributing about 30 percent of that volume. According to market analysts, foreign investors have been slow to enter the market. In fact, right after the war ended, CSE President Fonseka thought that there had been a net outflow of foreign investment, as the market became more liquid and some foreign investors were able to sell and get out. Now foreign investment appears to be coming back into Sri Lanka.

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Other new investors have not yet entered the market and seem to be reviewing the situation. Econoff recently spoke to a large U.S. hedge fund that was considering coming into Sri Lanka, but they were worried that they could have missed the boat and were too late.

¶7. The CSE with a market capitalization of Rs 1 trillion (\$8.6 billion) represents between a fourth and a fifth of the Sri Lankan economy. Channa De Silva, Director General of the Securities Exchange Commission, considers the optimism of the stakeholders of the CSE a reflection of the buoyancy of the economy. According to De Silva the ASPI is a leading indicator of the mainstream economy. It reflects economic prospects about 6 months ahead. However, factors constraining CSE growth could be the upcoming elections and market liquidity.

¶8. Comment. Although the Sri Lankan economy is starting to rebound (growth estimates are up to 4 percent for 2009), the enormous growth in the stock market appears to reflect a mix of improving economic prospects and speculation. There are a number of factors that could cloud the economic future, including uncontrolled government spending in advance of the presidential and parliamentary elections and the European Union pulling its GSP trade preferences. Nevertheless, the fact that local investors are leading the growth in stock prices demonstrates real confidence in the economic potential of Sri Lanka. End Comment.

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